CLERK'S COPY

TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 22

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

vs.

R. A. SPROUSE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED JANUARY 21, 1942
CERTIORARI GRANTED MAY 11, 1942

No. 9751

United States

Circuit Court of Appeals

For the Ninth Circuit.

R. A. SPROUSE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Transcript of the Record

Upon Petition to Review a Decision of the United States Board of Tax Appeals

PARKER PRINTING COMPANY, 545 SANSOME STREET, SAN FRANCISCO

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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APPEARANCES

For Taxpayer:
WILLIAM J. PIEPENBRINK, C.P.A.
CHAS. E. McCULLOCH, Esq.
THOS. B. STOEL, JR., Esq.

For Commissioner:
JOHN H. PIGG, Esq.

Docket No 98565

R. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DOCKET ENTRIES

1939

May 17—Petition received and filed. Taxpayer notified. (Fee paid)

" 17—Copy of petition served on General Counsel.

Jul. 5—Answer filed by General Counsel.

" 5—Request for Circuit hearing in Portland, Oregon filed by General Counsel.

" 10—Notice issued placing proceeding on Portland, Oregon calendar. Answer and request served.

Oct. 4—Hearing set Nov. 20, 1939 at Portland, Oregon.

1939

Nov. 24—Hearing had before Mr. Smith on merits. Submitted. Consolidated for hearing with dockets 98452, 98564, 5, 6, 7 & 8. Appearance of Charles E. McCulloch and Thos. B. Stoel, Jr. filed. Stipulation of Facts filed. Memo Authorities filed by respondent. Copy served on petitioner. Petitioner's brief due 1/2/40—respondent's due 2/1/40. Called 11/20/39.

Dec. 13—Transcript of hearing of 11/24/39, filed.

1940

Jan. 2—Brief and proposed findings of fact filed by taxpayer. 1/2/40 copy served.

Aug. 6—Findings of fact and opinion rendered, Smith, Div. 5. Decision will be entered for the respondent.

" 8—Decision entered, Smith, Div. 5.

Nov. 1—Petition for review by U. S. Circuit Court of Appeals, 9th Circuit, with assignments of error filed by taxpayer.

" 1—Proof of service filed by taxpayer.

1941

Jan. 17—Certified copy of order from the 9th Circuit extending the time to 2/15/41 for filing the record and further ordered copy of this order be included in the certified record transmitted to the Court filed.

1941

Jan. 30—Praecipe for record filed by taxpayer with proof of service thereon. No counter praecipe to be filed.

" 30—Notice of filing praecipe for record filed by taxpayer with proof of service thereon.

[1*]

United States Board of Tax Appeals

Docket No. 98565

R. A. SPROUSE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION

The above named petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency IT:90D:JAS dated February 25, 1939, and as a basis of his proceeding, alleges as follows:

1. The petitioner is an individual residing in the City of Oakland, County of Alameda, State of California, and his residence address is 244 Lakeside Drive, Oakland, California. The return for the period here involved was filed with the Collector for the First District of California.

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*Page numbering appearing at foot of page of original certified Transcript of Record.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A"), was mailed to the petitioner on February 25, 1939.

3. The taxes in controversy are income taxes for the year 1936, and in the amount of $16,562.37.

4. The determination of the tax set forth in the said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in failing and refusing to find that stock dividends paid during the year 1936 by [2] Sprouse-Reitz Co. Inc., in non-voting Common Stock on voting Common Stock, and in 7% Preferred Stock on voting Common Stock, do not constitute income under the Sixteenth Amendment.

(b) The Commissioner erred in failing and refusing to find that stock dividends in non-voting Common Stock on voting Common Stock, and in 7% Preferred Stock on voting Common Stock paid to petitioner by Sprouse-Reitz Co. Inc., during the year 1936 were not taxable dividends under Section 115(f) of Revenue Act of 1936.

5. The facts upon which the petitioner relies as the basis of this proceeding are as follows:

(a) During the year 1936 Sprouse-Reitz Co. Inc., paid stock dividends to petitioner in non-voting Common Stock on voting Common Stock, and in 7% Preferred Stock on voting Common Stock, which did not change his proportion of ownership in the net assets of the Corporation.

(b) After receipt of said stock dividends petitioner's interest in the net assets of Sprouse-Reitz Co. Inc., remained the same as before.

Wherefore, the petitioner prays that this Board may hear the proceeding and find that the additional income taxes asserted by respondent are erroneous and not due from petitioner.

WILLIAM J. PIEPENBRINK,
Counsel for Petitioner,
603-5 Wilcox Building,
Portland, Oregon. [3]

State of California,
County of Alameda—ss.

R. A. Sprouse, being duly sworn, says that he is the petitioner named in the foregoing petition; that he has read the same or had the same read to him and is familiar with the statements contained therein; that the statements made therein are true, except those stated to be upon information and belief, and that those he believes to be true.

R. A. SPROUSE

Witness:
[Illegible]

Subscribed and sworn to before me this 11th day of May, 1939.

[Seal] HARRY BLAIR [4]

Treasury Department
Internal Revenue Service,
Seattle, Washington

February 25, 1939

Seattle Division
350 Federal Office Building
IT:90D:JAS

Mr. R. A. Sprouse
c/o Mr. William J. Piepenbrink,
903-4 Wilcox Building,
Portland, Oregon

Sir:

You are advised that the determination of your income tax liability for the taxable year ended December 31, 1936, discloses a deficiency of $16,562.37 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days (Not counting Sunday or a legal holiday in the District of Columbia, as the 90th day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to Internal Revenue Agent in charge, Seattle, Washington for the attention of IT:90D:JAS. The signing and filing of this form will expedite the

closing of your return(s) by permitting an early assessment of the deficiency, and will prevent the accumulation of interest, since the interest period terminates 30 days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully,

GUY T. HELVERING,
Commissioner.

By GEO. C. EARLEY,
Internal Revenue Agent in Charge.

Enclosures:
Statement.
Form of Waiver.

JAS-bb [5]

STATEMENT

IT:90D:JAS

R. A. Sprouse,
c/o William J. Piepenbrink,
903-4 Wilcox Building,
Portland, Oregon

Tax Liability for the Taxable Year Ended December 31, 1936

	Liability	Assessed	Deficiency
Income Tax	$22,656.84	$6,094.47	$16,562.37

In making this determination of your income tax liability, careful consideration has been given to the report of examination dated June 4, 1938; to your protest dated July 9, 1938; and to the statements made at the conferences held on August 25, 1938, and January 10, 1939.

A copy of this letter and statement has been mailed to your representative, William J. Piepenbrink, 903-4 Wilcox Building, Portland, Oregon, in accordance with the authority contained in the power of attorney executed by you on file with the Bureau.

ADJUSTMENTS TO NET INCOME

Net income as disclosed by return	$40,357.88
Unallowable deductions and additional income:	
(a) Additional dividends	42,300.00
Net income adjusted	$82,657.88

EXPLANATION OF ADJUSTMENTS

(a) It is held that stock dividends paid to you during the taxable year 1936 by Sprouse-Reitz Co., Inc., in nonvoting common stock on voting common stock and in 7% preferred stock on voting common stock, constitute income under the Sixteenth Amendment to the Constitution and taxable dividends under Section 115(f) of the Revenue Act of 1936, to the extent of their fair market value at the time received by you, which is held to be their par value. [6]

COMPUTATION OF TAX

Taxable Year Ended December 31, 1936

Net income as adjusted	$82,657.88
Less:	
Personal exemption	2,500.00
Balance (Surtax net income)	$80,157.88
Less:	
Earned income credit (10% of $7,500.00)	750.00
	$79,407.88

Normal tax at 4% on $79,407.88	$ 3,176.32
Surtax on $76,157.88 (excess over $4,000.00)	19,480.52
Correct income tax liability	$22,656.84
Income tax assessed:	
Original. Account No. 204895 (1-Calif.)	6,094.47
Deficiency of income tax	$16,562.37

[Endorsed]: U. S. B. T. A. Filed May 17, 1939.

[7]

[Title of Board and Cause.]

ANSWER

Comes Now the Commissioner of Internal Revenue, by his attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and for answer to the petition filed herein, admits and denies as follows:

1. Admits the allegations contained in paragraph 1 of the petition.

2. Admits the allegations contained in paragraph 2 of the petition.

3. Admits the allegations contained in paragraph 3 of the petition.

4. Denies that he erred in his determination of the deficiency as shown by the notice of deficiency from which petitioner's appeal is taken. Specifically denies that he erred in the manner and form as alleged in subparagraphs (a) and (b) of paragraph 4 of the petition.

5(a) Admits that during the year 1936 Sprouse-Reitz Co. Inc., paid stock dividends to petitioner. For lack of sufficient information upon the basis of which to form a belief as to the truth or falsity thereof, denies the remaining allegations contained in sub- [8] paragraph (a) of paragraph 5 of the petition.

(b). Denies the allegations contained in sub-paragraph (b) of paragraph 5 of the petition.

6. Denies generally and specifically each and every material allegation contained in the petition herein, not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the petitioner's appeal be denied and that the Commissioner's determination of deficiency be approved.

Signed J. P. WENCHEL,
JHP,
Chief Counsel, Bureau of Internal Revenue.

Of Counsel:
ALVA C. BAIRD,
B. H. NEBLETT,
JOHN H. PIGG,
Special Attorneys,
Bureau of Internal Revenue.

[Endorsed]: U. S. B. T. A. Filed July 5, 1939.
JWP:[illegible] Jun. 27, 1939. [9]

United States Board of Tax Appeals

Docket No. 98452

JOHN M. KEISTER,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 98564

TRUST OF JOHN A. SPROUSE, UNITED STATES NATIONAL BANK OF PORTLAND (OREGON), TRUSTEE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 98565

R. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 98566

J. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent. [10]

Docket No. 98567

JENNIE G. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket No. 98568

CARRIE S. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto, by their respective attorneys, that the following facts are true, and that the same may be so taken and considered by the Board as offered in evidence by the parties to these proceedings.

1. Each of the petitioners is a stockholder of Sprouse-Reitz Co., Inc., which was organized under the laws of the State of Oregon, on February 10, 1920. The petitioners, John M. Keister, J. A. Sprouse, and Carrie S. Sprouse, are residents of Portland, Oregon, and filed their returns for the year 1936 with the Collector at Portland, Oregon. The petitioners, R. A. Sprouse and Jennie G. Sprouse, husband and wife, are residents of Oak-

land, California, and filed their returns for the year 1936 with the Collector for the First District of California. No income tax return (Form 1040) was filed by or for the petitioner, Trust of John A. Sprouse, for the year 1936, although a [11] fiduciary return of income (Form 1041) was filed for that petitioner for that year by the trustee, The United States National Bank, of Portland, (Oregon), with the Collector at Portland, Oregon.

2. On February 13, 1936, the Sprouse-Reitz Co., Inc., hereinafter referred to as the Company, had an authorized capital stock of $2,000,000.00 (par value), consisting of: (a) 6,000 shares voting common stock, of the par value of $100.00 per share; (b) 12,000 shares non-voting common stock, of the par value of $100.00 per share; and (c) 2,000 shares non-voting 7% cumulative preferred stock, of the par value of $100.00 per share, of which, there was outstanding at that time voting common stock of the par value of $397,471.25, and non-voting common stock of the par value of $819,333.06. None of the authorized preferred stock was outstanding at that time. The Company's articles of incorporation contain the following provision:

> "The preferred stock shall be entitled to a dividend of 7% annually upon the par value before any dividends are paid on either class of the common stock. The common stock shall be entitled to dividends equally on each class thereof after the dividends on the preferred stock are paid.

"The preferred stock and the non-voting common stock shall have no voting power. The preferred stock shall be made redeemable at any time after three years from the date of its issue, in the discretion of the board of directors, but such redemption shall be at par, and after all accrued dividends have been paid. In the event of liquidation or dissolution of the corporation all classes of stock shall share equally in the assets."

3. On February 13, 1936, the Company paid a 6% cash dividend of $73,008.26, of which $24,200.00 was paid to the holders of its voting [12] common stock, and $48,808.26 was paid to the holders of its non-voting common stock. On the same date, February 13, 1936, the Company paid a 10% stock dividend of $121,680.43 (par value) in non-voting common stock, of which $40,333.34 was paid to the holders of its voting common stock, and $81,347.09 was paid to the holders of its non-voting common stock.

4. On December 15, 1936, the Company paid a 10% cash dividend of $141,828.23, of which $42,633.33 was paid to the holders of its voting common stock, and $99,194.90 was paid to the holders of its non-voting common stock. On the same date, December 15, 1936, the Company paid a 10% stock dividend of $141,828.23 (par value) in non-voting 7% preferred stock, of which $42,633.33 was paid to the holders of its voting common stock and

$99,194.90 was paid to the holders of its non-voting common stock.

5. All of the Company's stockholders participated in the dividend distribution of February 13, 1936, and December 15, 1936, in proportion to their respective stockholdings, irrespective of whether they held voting or non-voting common stock. The fair market value of the Company's non-voting common stock at the time of the distribution thereof to its stockholders as a stock dividend, on February 13, 1936, was $100.00 per share. The fair market value of the Company's non-voting 7% preferred stock at the time of the distribution thereof to its stockholders as a stock dividend, on December 15, 1936, was $100.00 per share. On February 13, 1936, the Company's earnings or profits [13] available for distribution were of an amount of not less than $200,000.00, and on December 15, 1936, the Company's earnings or profits available for distribution were of an amount of not less than $300,000.00.

6. The following tabulation shows: (a) the amount (par value) of the Company's non-voting common stock received by the petitioners on February 13, 1936, as a dividend on their non-voting common stock; (b) the amount (par value) of the Company's non-voting common stock received by the petitioners on February 13, 1936, as a dividend on their voting common stock; (c) the amount (par value) of the Company's 7% preferred stock received by the petitioners on December 15, 1936,

as a dividend on their voting common stock; (d) the amount (par value) of the Company's 7% preferred stock received by the petitioners on December 15, 1936, as a dividend on their non-voting common stock; and (e) the amounts by which the Commissioner has increased the net incomes as reported by the respective petitioners for the year 1936; [14].

	(a) Non-voting common stock (par value) received on 2-13-36, as dividend on non-voting common stock	(b) Non-voting common stock (par value) received on 2-13-36, as dividend on voting common stock	(c) Non-voting 7% preferred stock (par value) received on 12-15-36, as dividend on voting common stock	(d) Non-voting 7% preferred stock (par value) received on 12-15-36, as dividend on non-voting common stock	(e) Amounts by which petitioners' reported income for 1936 has been increased by respondent
Trust of John A. Sprouse, Deceased	—	$8,000.00	$8,000.00	$ 800.00	$16,800.00
J. A. Sprouse	$ 414.73	4,508.72	4,508.72	907.07	9,924.51
Carrie S. Sprouse	1,909.99	3,193.46	3,779.67	2,420.33	9,979.67
R. A. Sprouse	—	20,000.00	22,300.00	- -	42,300.00
Jennie G. Sprouse	83.45	317.90	317.90	123.59	759.39
John M. Keister	2,028.88	1,721.12	1,721.12	2,028.88	5,471.12

7. In none of the returns filed by or for any of the petitioners for the year 1936 was there any amount reported for or on account of the stock dividends received by them during that year, as above set forth. In his determination of the deficiencies involved, the Commissioner increased the net incomes as reported by the petitioners for the year [illegible] by the respective amounts as shown in column (e) of paragraph 6, above, on the ground that the stock dividends in question, both non-voting common and preferred, constitute taxable income under the Sixteenth Amendment to the Constitution, and within the meaning of section 115(f) of the Revenue Act of 1936. It was further held by the Commissioner that the stock dividends represented taxable income to the extent of their fair market value, which was determined by him to be equal to their par value. No part of the amounts appearing in column (a) of paragraph 6, above, has been included by the [15] Commissioner in the taxable incomes, as determined by him, of the petitioners opposite whose names such amounts appear.

8. The amount of $9,979.67, appearing in column (e) of paragraph 6, above, as representing the amount by which respondent increased the net income as reported by Carrie S. Sprouse for the year 1936, included the sum of $3,779.67, as the amount of the non-voting common stock (par value) received by her on February 13, 1936, as a dividend on voting common stock, instead of the amount of

$3,193.46, shown in column (b) of paragraph 6, above.

/S/ CHARLES E. McCULLOCH,
/S/ THOMAS B. STOEL, JR.,
Counsel for Petitioner.
/S/ J. P. WENCHEL, ACB,
Chief Counsel, Bureau of Internal Revenue,
Counsel for Respondent.

JHP:[Illegible] 11-17-39

[Endorsed]: U. S. B. T. A. Filed at hearing. Nov. 24, 1939. [16]

United States Board of Tax Appeals

JOHN M. KEISTER,

Petitioner,[1]

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket Nos. 98452, 98564-98568.

Promulgated August 6, 1940.

FINDING OF FACT AND OPINION

1. A stock dividend paid in non-voting common stock to the holders of voting common

[1] Proceedings of the following petitioners are consolidated herewith: Trust of John A. Sprouse United States National Bank of Portland (Oregon) Trustee; R. A. Sprouse; J. A. Sprouse; Jennie G. Sprouse; and Carrie S. Sprouse.

stock and nonvoting common stock is a taxable dividend to the holders of voting common stock.

2. A stock dividend paid in nonvoting 7 percent preferred stock to the holders of voting common stock and to the holders of nonvoting common stock is a taxable dividend to both classes of stockholders. Koshland v. Helvering, 298 U. S. 446.

CHARLES E. McCULLOCH, Esq.,
and
THOMAS B. STOEL, JR., Esq.,
For the Petitioners.

JOHN H. PIGG, Esq.,
For the respondent.

These proceedings, consolidated for hearing, involve income tax deficiencies for 1936 as follows:

Petitioner	Docket No.	Deficiency
John M. Keister	98452	$510.92
Trust of John A. Sprouse, United States National Bank of Portland (Oregon), Trustee	98564	1,394.00
R. A. Sprouse	98565	16,562.37
J. A. Sprouse	98566	1,329.97
Jennie G. Sprouse	98567	75.95
Carrie S. Sprouse	98568	2,197.87

The petitioners allege that the respondent erred in including in their gross income the value of certain shares of stock issued to them as stock dividends in nonvoting common stock and in nonvoting 7 percent preferred stock of the Sprouse-Reitz Co. All of the facts have been stipulated.

FINDINGS OF FACT.

1. Each of the petitioners is a stockholder of Sprouse-Reitz Co., a corporation organized under the laws of the State of Oregon on [17] February 10, 1920. The petitioners, John M. Keister, J. A. Sprouse, and Carrie S. Sprouse, are residents of Portland, Oregon, and filed their returns for 1936 with the collector at Portland. The petitioners, R. A. Sprouse and Jennie G. Sprouse, are husband and wife and are residents of Oakland, California. They filed their returns for the year 1936 with the collector for the first district of California. No income tax return (Form 1040) was filed by or for the petitioner, Trust of John A. Sprouse, for the year 1936, although a fiduciary return of income (Form 1041) was filed for the petitioner for that year by the trustee, the United States National Bank of Portland, with the collector at Portland.

2. On February 13, 1936, the Sprouse-Reitz Co., hereinafter sometimes referred to as the company, had an authorized capital stock of $2,000,000 (par value) consisting of: (a) 6,000 shares of voting common stock of the par value of $100 per share; (b) 12,000 shares of nonvoting common stock of the par value of $100 per share; and (c) 2,000 shares of nonvoting 7 percent cumulative preferred stock of the par value of $100 per share, of which there was outstanding at that time voting common stock of the par value of $397,471.25, and nonvoting common stock of the par value of $819,333.06. None of the authorized preferred stock was outstanding at

that time. The company's articles of incorporation contain the following provision:

> The preferred stock shall be entitled to a dividend of 7 percent annually upon the par value before any dividends are paid on either class of the common stock. The common stock shall be entitled to dividends equally on each class thereof after the dividends on the preferred stock are paid.
>
> The preferred stock and the nonvoting common stock shall have no voting power. The preferred stock shall be made redeemable at any time after three years from the date of its issue, in the discretion of the board of directors, but such redemption shall be at par, and after all accrued dividends have been paid. In the event of liquidation or dissolution of the corporation all classes of stock shall share equally in the assets.

3. On February 13, 1936, the company paid a 10 percent stock dividend on its voting and nonvoting common stock of $121,680.43 (par value) in nonvoting common stock, of which $40,333.34 was paid on its voting common stock and $81,347.09 on its nonvoting common stock.

4. On December 15, 1936, the company paid a 10 percent stock dividend on its voting and nonvoting common stock of $141,828.23 (par value) in nonvoting 7 percent preferred stock, of which $42,633.33 was paid on its voting common stock, and $99,194.90 on its nonvoting common stock.

5. All of the company's stockholders, whether they held voting or nonvoting common stock, participated in the dividend distributions of February 13 and December 15, 1936, in proportion to their respec- [18] tive stockholdings. The fair market value of the company's nonvoting common stock at the time of the distribution thereof to its stockholders as a stock dividend on February 13, 1936, was $100 per share. The fair market value of the company's nonvoting 7 percent preferred stock at the time of the distribution thereof to its stockholders as a stock dividend on December 15, 1936, was $100 per share.

6. The following tabulation shows (a) the amount (par value) of the company's nonvoting common stock received by the petitioners on February 13, 1936, as a dividend on their nonvoting common stock; (b) the amount (par value) of the company's nonvoting common stock received by the petitioners on February 13, 1936, as a dividend on their voting common stock; (c) the amount (par value) of the company's 7 percent preferred stock received by the petitioners on December 15, 1936, as a dividend on their voting common stock; (d) the amount (par value) of the company's 7 percent preferred stock received by the petitioners on December 15, 1936, as a dividend on their nonvoting common stock; and (e) the amounts by which the respondent has increased the net incomes as reported by the respective petitioners for the year 1936:

Name	(a) Non-voting common stock (par value) received on 2-13-36, as dividend on non-voting common stock	(b) Non-voting common stock (par value) received on 2-13-36, as dividend on voting common stock	(c) Non-voting 7% preferred stock (par value) received on 12-15-36, as dividend on voting common stock	(d) Non-voting 7% preferred stock (par value) received on 12-15-36, as dividend on non-voting common stock	(e) Amounts by which petitioners' reported income for 1936 has been increased by respondent
Trust of John A. Sprouse, Deceased	—	$8,000.00	$8,000.00	$ 800.00	$16,800.00
J. A. Sprouse	$ 414.73	4,508.72	4,508.72	907.07	9,924.51
Carrie S. Sprouse	1,909.99	3,193.46	3,779.67	2,420.33	9,979.67
R. A. Sprouse	—	20,000.00	22,300.00	—	42,300.00
Jenhie G. Sprouse	83.45	317.90	317.90	123.59	759.39
John M. Keister	2,028.88	1,721.12	1,721.12	2,028.88	5,471.12

7. In none of the returns filed by or for any of the petitioners for the year 1936 was there reported any amount on account of the stock dividends received by them during that year as above set forth. In his determination of the deficiencies involved the respondent increased the net incomes as reported by the petitioners for the year 1936 by the respective amounts as shown in column (e) of paragraph 6, above, on the ground that the stock dividends in question, both nonvoting common and preferred, constituted taxable income under the Sixteenth Amendment to the Constitution and within the meaning of section 115 (f) of the Revenue Act of 1936. It was further held by the respondent that the stock dividends represented taxable income to the extent of their fair market value, which was determined by him to be equal to their par value. No part of the amounts ap- [19] pearing in column (a) of paragraph 6, above, has been included by the respondent in the taxable incomes of the respective petitioners as determined by him.

8. The amount of $9,979.67, appearing in column (e) of paragraph 6, above, as representing the amount by which respondent increased the net income as reported by Carrie S. Sprouse for the year 1936, included the sum of $3,779.67 as the amount of the nonvoting common stock (par value) received by her on February 13, 1936, as a dividend on voting common stock, instead of the amount of $3,193.46 shown in column (b) of paragraph 6, above.

OPINION.

Smith: The questions for our determination in these proceedings are whether the distributions which the Sprouse-Reitz Co. made in 1936 of its nonvoting common stock to holders of voting common stock, and of its nonvoting 7 percent preferred stock to holders of its voting common stock and its nonvoting common stock were taxable dividends within the meaning of section 115 (f) of the Revenue Act of 1936.

Section 115 of the Revenue Act of 1936 provides in part:

> Sec. 115. Distributions by Corporations.
>
> (a) Definition of Dividend.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.
>
> * * * * * *
>
> (f) Stock Dividends.—
>
> (1) General Rule.—A distribution made by a corporation to its shareholders in its stock

or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

In Eisner v. Macomber, 252 U. S. 189, it was held that a distribution of common stock as a dividend on common stock did not constitute income within the meaning of the Sixteenth Amendment and that an income tax law attempting to tax such a stock dividend was invalid. In Koshland v. Helvering, 298 U. S. 441, it was held that common voting stock issued as a dividend on cumulative nonvoting preferred stock constituted income to the recipients and not return of capital. In its opinion the Court sad:

> Although Eisner v. Macomber affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer, the Treasury [20] gave the decision a broader interpretation which Congress followed in the act of 1921. Soon after the passage of that act, this court pointed out the distinction between a stock dividend which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where there had either been changes of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the stockholder after the distribu-

> tion was essentially different from his former interest. * * * [Citing United States v. Phellis, 257 U. S. 156; Rockefeller v. United States, 257 U. S. 176; Cullinan v. Walker, 262 U. S. 134; Marr v. United States, 268 U. S. 536.]
>
> * * * Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old, the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old, does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. * * *

At the time the corporation here made the dividend distribution of its nonvoting common stock on February 13, 1936, there were outstanding only two classes of stock, voting common shares and nonvoting common shares. The holders of both classes of stock shared alike in the distribution. The Commissioner treated the distribution as a taxable dividend to the voting common stockholders but not to the nonvoting common stockholders.

The respondent makes the argument that the voting shares and the nonvoting shares represented different property rights and that the holders of the nonvoting shares might have transferred them

without in any way disturbing the voting control, citing Frank J. and Hubert Kelly Trust, 38 B. T. A. 1014. In that case there was a stock dividend of preferred shares on common shares, only common shares being outstanding at the time. The question at issue was whether in determining the profit upon the sale of the preferred shares they should be given a cost basis of an allocable portion of the cost of the common shares. We held that although by specific statute the dividend in the preferred shares was exempt from income tax as a stock dividend, such preferred shares were nevertheless income under the Sixteenth Amendment, and the decisions of the Supreme Court, and that the entire amount received from their subsequent sale constituted taxable income. The situation there was the converse of that in the Koshland case, where common voting shares were issued as a stock dividend on preferred nonvoting shares. In its opinion the Board said:

> * * * But entirely apart from this, the undeniable difference in the situation of the stockholders is that their interest, after the dividend, became to some extent transferable in parts where before it could be disposed of only as a [21] whole. Before the dividend, it is true, a stockholder could have sold a portion of his common shares. But, as pointed out in the Macomber case, supra, p. 212, it is "in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the

entire capital stock." After the preferred stock was issued this was no longer true. Petitioner's donors, by transferring the preferred stock, as in fact they did, could then dispose of a part of their interest in the earnings and assets of the corporation without in any way disturbing the distribution of voting control. Or they could retain the preferred stock as representing a property interest and divest themselves of the powers of management. We find it impossible to conclude that this situation did not result in a substantial alteration of the interest of the stockholders. * * *

The portion of the Court's opinion in Eisner v. Macomber, supra, from which the above quotation was taken, reads as follows:

It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before

the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock of a corporation should receive in common with other stockholders a 50 per cent. stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having six-fifteenths instead of six-tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock; it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power—that "right preservative of rights" in the control of a corporation. Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.

In Chapman v. United States, 63 Ct. Cls. 106, it was held under the doctrine of Eisner v. Macomber, supra, a distribution of nonvoting common stock as a dividend on voting common stock was a non-

taxable stock dividend. Certiorari was denied by the Supreme Court, 275 U. S. 524. Denial of Certiorari was, however, prior to the decision of the Supreme Court in Koshland v. Helvering, supra. As many times pointed out by the Supreme Court, denial of a writ of certiorari in a given case is not tantamount to the affirmance of the decision of the court below. [22]

We think that under the opinion of the Supreme Court in the Koshland case the petitioners who received on their voting common stock a dividend of nonvoting common shares received a taxable dividend. The nonvoting common stock was not "of precisely the same character" as the stock previously held by them. By the receipt of the dividend each holder of voting common stock received an "interest different from that which its former stockholdings represented." In making this observation we do not overlook the fact that the value of the additional nonvoting common shares received was presumably no greater than a like number of voting common shares which would not be subject to income tax under the opinion in Eisner v. Macomber, supra. Probably the shares had a less value. But the interest was different, and we think that is all that is required to make the dividend taxable to the holders of voting common stock.

The dividend of the 7 percent nonvoting preferred stock on the voting and nonvoting common stock, which was distributed December 15, 1936, presents a situation even more favorable to the

respondent. This stock was entitled to 7 percent annual dividends before any dividends could be paid on the common voting or nonvoting shares. It was redeemable at par after three years from the date of issue in the discretion of the directors and after payment of all accrued dividends. These features gave it an entirely different character from the voting and nonvoting common shares. It clearly represented a different interest in the corporation. It is true, as petitioners point out, that the preferred shares were not to be favored in case of liquidation or dissolution and it is to be noted further that their issuance did not in any way affect the voting control of the corporation, but nevertheless, under the authoritative cases, they represented a new and different interest in the corporation and therefore constituted taxable income. Koshland v. Helvering, supra; Frank J. and Hubert Kelly Trust, supra; Albert E. Smith, 39 B. T. A. 80.

Reviewed by the Board.

Decisions will be entered for the respondent in Docket Nos. 98452, 98564, 98565, 98566, and 98567, and under Rule 50 in Docket No. 98568.

[23]

United States Board of Tax Appeals
Washington

Docket No. 98565

R. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

DECISION

Pursuant to the determination of the Board, as set forth in its Findings of Fact and Opinion, promulgated August 6, 1940, it is

Ordered and Decided: That there is a deficiency in income tax of $16,562.37 for the year 1936.

Enter:

[Seal] (Sgd) CHARLES P. SMITH,
Member.

Entered Aug. 8, 1940. [24]

United States Circuit Court of Appeals
For the Ninth Circuit

Docket No. 98565

R. A. SPROUSE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR REVIEW BY THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

To the Honorable, the Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

I.

Jurisdiction

R. A. Sprouse, your petitioner, respectfully petitions this Honorable Court to review the decision of the United States Board of Tax Appeals entered on August 6, 1940, and finding a deficiency in income tax due from your petitioner for the calendar year 1936 in the amount of $16,562.37.

Your petitioner at the time of filing this petition [25] is a citizen of the United States and resides at Oakland, Alameda County, California.

The return of income tax in respect of which the aforementioned tax liability arose was filed by your petitioner with the Collector of Internal Revenue for the First Collection District of California lo-

cated in the City of San Francisco, California, which is situated within the jurisdiction of the Circuit Court of Appeals for the Ninth Judicial District.

The jurisdiction of this Court to review the decision of the United States Board of Tax Appeals aforesaid is founded on Section 1141 and Section 1142 of the Internal Revenue Code.

II.

Nature of the Controversy

The proceeding was submitted to the Board of Tax Appeals on a stipulation of facts. The stipulated facts show that the petitioner is a resident of Oakland, California, and was, on February 13, 1936, the owner of certain shares of the voting common stock of Sprouse-Reitz Co., Inc., hereinafter called the "Company." On that date the Company declared a stock dividend in nonvoting common stock payable to the holders of its voting common stock. As a result of the stock dividend so [26] paid, petitioner received 200 shares of the Company's nonvoting common stock of a total par value of $20,000. The fair market value of such nonvoting common stock on February 13, 1936, was $100 per share. The Company's earnings or profits available for distribution on February 13, 1936, were not less than $200,000.

The stipulated facts further show that on February 13, 1936, the Company had authorized and outstanding voting common stock of the par value

of $397,471.25 and nonvoting common stock of the par value of $819,333.06. The voting common stock and the nonvoting common stock conferred precisely the same rights upon shareholders, except that the nonvoting common stock had no voting power. The Company had no other classes of stock outstanding on February 13, 1936.

The Commissioner of Internal Revenue determined that the petitioner's taxable income for 1936 should include the sum of $20,000 on the ground that the stock dividend in nonvoting common stock paid by the Company on February 13, 1936, to holders of its voting common stock resulted in the receipt by petitioner of taxable income to the extent of the fair market value of the nonvoting common shares so received by him. The petitioner filed his petition to the Board of Tax Appeals seeking a redetermination of the deficiency [27] asserted by the Commissioner, and alleging error in the Commissioner's failure to find that the stock dividend paid to the petitioner in nonvoting common stock upon his voting common stock did not constitute income within the meaning of the Sixteenth Amendment to the Constitution of the United States and was not a taxable dividend under Section 115(f) of the Revenue Act of 1936.

In the proceedings before the Board the petitioner contended that the payment of the stock dividend in nonvoting common stock upon voting common stock, at a time when only common stock of both classes was outstanding, did not alter his

pre-existing proportionate interest in the Company nor give him substantially different interests in the Company. Therefore petitioner asserted that the distribution of such nonvoting common stock as a dividend on voting common stock did not constitute income within the meaning of the Sixteenth Amendment to the Constitution, and was not a taxable dividend under Section 115(f) of the Revenue Act of 1936.

No review is here sought of the Board's decision and order with respect to other issues raised by petitioner's petition to the Board.

The Board of Tax Appeals held:

(1) That the distribution which the Sprouse-Reitz Co., Inc., made on February 13, 1936, of its nonvoting common stock to holders of its voting common stock constituted [28] income within the meaning of the Sixteenth Amendment to the Constitution of the United States.

(2) That the distributions which the Sprouse-Reitz Co., Inc., made on February 13, 1936, of its nonvoting common stock to holders of its voting common stock were taxable dividends within the meaning of Section 115(f) of the Revenue Act of 1936.

III.

ASSIGNMENT OF ERRORS

In making its decision as aforesaid the United States Board of Tax Appeals committed the fol-

lowing errors upon which your petitioner relies as the basis of this proceeding:

1. The Board erred in holding that the distributions of nonvoting common stock to holders of voting common stock in Sprouse-Reitz Co., Inc., were income within the meaning of the Sixteenth Amendment to the Constitution of the United States.

2. The Board erred in holding that distributions in nonvoting common stock to holders of voting common stock in Sprouse-Reitz Co., Inc., were taxable dividends under Section 115(f) of the Revenue Act of 1936.

3. The Board erred in holding that the fair market [29] value of the nonvoting common stock received by petitioner on February 13, 1936, as a dividend upon his voting common stock should be included in petitioner's income for the calendar year 1936.

4. The Board erred in rendering its decision in favor of respondent and against petitioner for a deficiency of $16,562.37, or for any deficiency in excess of $7,297.11 in petitioner's income tax for the calendar year 1936.

Wherefore, your petitioner prays that this Honorable Court may review the decision and order of the United States Board of Tax Appeals and reverse and set aside the same to the extent that it holds that the nonvoting common stock received by petitioner as a dividend upon his voting common stock constituted taxable income to him; and for the entry of such further orders and directions as

shall by this Court be deemed meet and proper, in accordance with law.

CHARLES E. McCULLOCH,
THOMAS B. STOEL, JR.,
Counsel for Petitioner,
1410 Yeon Building,
Portland, Oregon. [30]

State of Oregon,
County of Multnomah—ss.

Charles E. McCulloch, being duly sworn, says:

I am one of the attorneys for the petitioner in this proceeding; I prepared the foregoing petition and am familiar with the contents thereof. The allegations of fact contained therein are true to the best of my knowledge, information and belief. This petition is not filed for the purpose of delay, and I believe the petitioner is justly entitled to the relief sought.

CHARLES E. McCULLOCH

Subscribed and sworn to before me this 30th day of October, 1940.

(Notarial Seal) T. A. RUTHERFORD
Notary Public for Oregon

My commission expires: Oct. 6, 1943

[Endorsed]: U.S.B.T.A. Filed Nov. 1, 1940. [31]

[Title of Board and Cause.]

NOTICE OF FILING PETITION FOR REVIEW AND ACCEPTANCE OF SERVICE THEREOF

To:

Commissioner of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

J. P. Wenchel, Attorney for Respondent,
Chief Counsel,
Bureau of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

You Are Hereby Notified that on the 1st day of November, 1940, a petition for review by the United States Circuit Court of Appeals for the Ninth Circuit of the decision [32] of the United States Board of Tax Appeals heretofore rendered in the above entitled cause, was filed with the Clerk of the Board. A copy of the petition as filed is attached hereto and served upon you.

Dated at Portland, Oregon, this 30th day of October, 1940.

CHARLES E. McCULLOCH
THOMAS B. STOEL, JR.
Counsel for Petitioner,
1410 Yeon Building,
Portland, Oregon.

Service of the foregoing Notice of Filing and of

a copy of the Petition For Review is hereby acknowledged this 1st day of November, 1940.

J. P. WENCHEL
C.P.R.
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent.

[Endorsed]: U.S.B.T.A. Filed Nov. 1, 1940. [33]

United States Circuit Court of Appeals
for the Ninth Circuit

No. 9751

(B. T. A. Docket No. 98565)

R. A. SPROUSE,

Petitioner.

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PRAECIPE FOR RECORD

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit, and deliver to the Clerk of the United States Circuit Court of Appeals for the Ninth Circuit copies duly certified of the following documents and records in the above entitled cause in connection with the petition for review by the said Circuit Court of Appeals for

the Ninth Circuit, heretofore filed by the above named petitioner:

1. The docket entries of the proceedings before the United States Board of Tax Appeals;
2. Petition filed on May 17, 1939; [34]
3. Answer filed on July 5, 1939;
4. Stipulation of facts filed with the Board at the hearing on November 24, 1939;
5. Findings of fact and opinion of the Board, promulgated August 6, 1940, and decision of the Board entered August 6, 1940;
6. Petition for review by the United States Circuit Court of Appeals for the Ninth Circuit, filed on November 1, 1940;
7. Notice of filing petition for review, filed on November 1, 1940;
8. This praecipe for record;
9. Notice of filing this praecipe for record and the admission of service thereof.

CHARLES E. McCULLOCH
THOMAS B. STOEL, JR.
Attorneys for Petitioner
1410 Yeon Building
Portland, Oregon

Service of a copy of this praecipe is hereby admitted this 30th day of January, 1941. A counter-praecipe will not be filed.

J. P. WENCHEL
W
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent

[Endorsed]: U.S.B.T.A. Filed Jan. 30, 1941. [35]

United States Circuit Court of Appeals
for the Ninth Circuit

[Title of Cause.]

NOTICE OF FILING PRAECIPE

To: Commissioner of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

J. P. Wenchel, Attorney for Respondent,
Chief Counsel,
Bureau of Internal Revenue,
Internal Revenue Building,
Washington, D. C.

Please Take Notice that on the 30th day of January, 1941, the undersigned, attorneys for R. A. Sprouse, [36] the petitioner in the above entitled proceeding, have filed with the Clerk of the United States Board of Tax Appeals a Praecipe for Record, a copy of which is annexed hereto.

CHARLES E. McCULLOCH
THOMAS B. STOEL, JR.
Attorneys for Petitioner
1410 Yeon Building
Portland, Oregon

Dated: January 23, 1941

Receipt of the foregoing notice of filing the praecipe for record and service of a copy of the praecipe herein mentioned is acknowledged this 30th day of January, 1941.

J. P. WENCHEL
W
Chief Counsel, Bureau of Internal Revenue, Attorney for Respondent

[Endorsed]: U.S.B.T.A. Filed Jan. 30, 1941. [37]

United States Circuit Court of Appeals
for the Ninth Circuit

[Title of Cause.]

ORDER EXTENDING TIME FOR FILING RECORD UPON APPEAL

Upon application of R. A. Sprouse, petitioner in the foregoing proceeding, for extension of time to file in this court the record on appeal from an order of the United States Board of Tax Appeals finding a deficiency in the petitioner's federal income tax for the year 1936, and for cause shown,

It Is Ordered that the time for filing the record on appeal herein be and is hereby extended to February 15, 1941, and

It Is Further Ordered that the Clerk of this Court transmit a certified copy of the order of this Court entered hereunder to the Clerk of the United States Board of Tax Appeals, to be included by him in the certified record transmitted to this court.

Dated January 8th, 1941.

CURTIS D. WILBUR
U. S. Circuit Judge

[Endorsed]: Filed Jan. 8, 1941. Paul P. O'Brien, Clerk.

A True Copy

Attest: Jan. 13, 1941

(Seal) (s) PAUL P. O'BRIEN
Clerk.

[Endorsed]: U.S.B.T.A. Filed Jan. 17, 1941 [38]

[Title of Board and Cause.]

CERTIFICATE

I, B. D. Gamble, clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages, 1 to 38, inclusive, contain and are a true copy of the transcript of record, papers, and proceedings on file and of record in my office as called for by the Praecipe in the appeal (or appeals) as above numbered and entitled.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 3d day of February, 1941.

(Seal) B. D. GAMBLE

Clerk, United States Board of Tax Appeals.

[Endorsed]: No. 9751. United States Circuit Court of Appeals for the Ninth Circuit. R. A. Sprouse, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed February 19, 1941.

PAUL P. O'BRIEN,

Clerk of the United States Circuit Court of Appeals for the Ninth Circuit.

United States Circuit Court of Appeals
for the Ninth Circuit

No. 9751

R. A. SPROUSE,

Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

STATEMENT OF POINTS RELIED UPON AND DESIGNATION OF PARTS OF RECORD

Appellant, R. A. Sprouse, having filed his petition for review by the above entitled court of the decision of the Board of Tax Appeals entered on August 6, 1940, and finding a deficiency in federal income tax due from appellant for the calendar year 1936 in the amount of $16,562.37 specifies the following as the points upon which he intends to rely upon the appeal:

1. The Board erred in holding that the distributions of nonvoting common stock to holders of voting common stock in Sprouse-Reitz Co., Inc. were income within the meaning of the Sixteenth Amendment to the Constitution of the United States.

2. The Board erred in holding that distributions in nonvoting common stock to holders of voting common stock in Sprouse-Reitz Co., Inc., were taxable dividends under Section 115(f) of the Revenue Act of 1936.

3. The Board erred in holding that the fair market value of the nonvoting common stock received by appellant on February 13, 1936, as a dividend upon his voting common stock should be included in appellant's income for the calendar year 1936.

4. The Board erred in rendering its decision in favor of appellee and against appellant for a deficiency of $16,562.37, or for any deficiency in excess of $7,297.11 in appellant's income tax for the calendar year 1936.

Appellant hereby designates as the parts of the record which he thinks necessary for consideration the entire transcript of record as certified by the Clerk of the Board of Tax Appeals to the above entitled court, together with this statement of points relied upon and designation of parts of record.

CHARLES E. McCULLOCH
THOMAS B. STOEL, JR.
1410 Yeon Building,
Portland, Oregon.
Counsel for Appellant.

State of Oregon,
County of Multnomah—ss.

I, Thomas B. Stoel, Jr., being first duly sworn on oath depose and say:

On February 25, 1941, I deposited in the United States mail a registered letter containing a duly certified copy of the attached statement of points relied upon and designation of parts of record. Said

letter was addressed to the appellee's attorney, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, Washington, D. C., with postage prepaid.

THOMAS B. STOEL, JR.

Subscribed and sworn to before me this 25th day of February, 1941.

(Seal) T. A. RUTHERFORD

Notary Public for Oregon

My commission expires Oct. 6, 1943.

[Endorsed]: Filed Feb. 27, 1941. Paul P. O'Brien, Clerk.

UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

No. 9751

R. A. SPROUSE

v.

COMMISSIONER OF INTERNAL REVENUE

Excerpt from Proceedings of Monday, September 15, 1941

Before GARRECHT, HANEY, and HEALY, Circuit Judges

Order of submission.

Ordered petition to review herein argued by Mr. Thomas B. Stoel, Jr., counsel for petitioner, and by Mr. Warren F. Wattles, Special Assistant to the Attorney General, counsel for respondent, and submitted to the court for consideration and decision.

Excerpt from Proceedings of Wednesday, October 22, 1941

Before GARRECHT, HANEY, and HEALY, Circuit Judges

Order directing filing of opinion and filing and recording of judgment

By direction of the Court, ordered that the typewritten opinion this day rendered by this Court in above cause be forthwith filed by the clerk, and that a judgment be filed and recorded in the minutes of this court in accordance with the opinion rendered.

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 9751. Oct. 22, 1941

R. A. SPROUSE, PETITIONER

vs.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Upon Petition to Review a Decision of the United States Board of Tax Appeals

Before GARRECHT, HANEY, and HEALY, Circuit Judges

HANEY, Circuit Judge.

Petitioner seeks review of a decision of the Board of Tax Appeals holding that a stock dividend received by him was taxable income.

Sprouse-Reitz Co., Inc., was organized under the laws of Oregon on February 20, 1920. On February 13, 1936, its capital stock authorized and issued, was as follows:

Class	Authorized	Issued
$100 par voting common	$800,000	$397,471.25
$100 par non-voting common	1,200,000	819,333.75
$100 par 7% cumulative preferred	200,000	none
Totals	2,000,000	1,216,805.00

Its articles of incorporation contained the following provisions:

"The preferred stock shall be entitled to a dividend of 7% annually upon the par value before any dividends are paid on either class of the common stock. The common stock shall be entitled to dividends equally on each class thereof after the dividends on the preferred stock are paid.

"The preferred stock and the non-voting common stock shall have no voting power. The preferred stock shall be made redeemable at any time after three years from the date of its issue, in the discretion of the board of directors, but such redemption shall be at par, and after all accrued dividends have been paid. In the event of liquidation or dissolution of the corporation all classes of stock shall share equally in the assets."

On February 13, 1936, the corporation distributed a 10% stock dividend in non-voting common stock, divided between the holders of voting common and non-voting common stock. On December 15, 1936, the corporation distributed a 10% stock dividend in 7% cumulative preferred stock, divided between the holders of voting common and non-voting common stock. The fair market value of the stocks so distributed was the par value thereof. The stock dividends were distributed in addition to the payment of cash dividends. At the time of the distribution of the stock dividend, the corporation's earnings or profits available for distribution were not less than $200,000.

Petitioner owned only voting common stock immediately prior to the declaration of the first stock dividend. He received non-voting common stock, pursuant to the first stock dividend, having a fair market value of $20,000. He received 7% cumulative preferred stock, pursuant to the second stock dividend, having a fair market value of $22,300. He reported neither amount in his income tax return for 1936. Respondent audited petitioner's return, included therein as taxable income received by petitioner in 1936, the amount of $42,300, and assessed a deficiency in tax. The Board upheld respondent. Petitioner then filed the instant petition seeking review of that part of the Board's decision which upheld the inclusion of $20,000 as taxable income, such amount

representing the value of the non-voting common stock received by petitioner as a dividend.

The Sixteenth Amendment of the Constitution provides in part that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived. * * *" The Revenue Act of 1936, § 22, provides that "gross income" includes "dividends." Section 115 (f) (1) provides:

"A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

The Board held that the nonvoting common stock received by petitioner as a dividend was not "of precisely the same character," as the voting common stock, and each voting common stockholder received an "interest different from that which its former stockholdings represented." It concluded that the value of the nonvoting common stock was taxable income under Koshland v. Helvering, 298 U. S. 441.

It is conceded that under the taxing act the value of the nonvoting common stock, distributed to petitioner as a dividend, was taxable if it was "income" of the kind which the Sixteenth Amendment authorizes Congress to tax. Petitioner contends that the Sixteenth Amendment does not authorize taxation of the kind of income represented by the nonvoting common stock. Respondent contends to the contrary. A determination of what is meant by the word "income" in the Sixteenth Amendment will solve the question presented. The Sixteenth Amendment "did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the States of taxes laid on income." Eisner v. Macomber, 252 U. S. 189, 206.

The meaning of the word "income" in the Sixteenth Amendment is the same as the word has, when "used in common speech" and is the gain derived from or through a sale or conversion of capital assets, from labor, or from both combined. Eisner v. Macomber, supra, 207. The same case explains that income is "not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being 'derived,' that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit, and disposal; that is income derived from property" (p. 207).

Generally, insofar as the stockholder is concerned, the three main differences in stocks are in the rights (1) to an interest in the assets of the corporation, the differences being in the amount of such interest and the preference it may have over other interests in the corporation; (2) to dividends, the differences being in the absoluteness of the right, and whether such right is cumulative; and (3) to manage and control the corporate enture by voting.

The Board was of the view, as appellee argues here, that if the stock distributed as a dividend, differed in its nature from that held by the stockholder, the latter derived income. In other words, differences in such characteristics as preference in interest in the assets and in dividends, and the right to vote, are proposed as the test to determine whether the recipient of the stock dividend has derived income. We think such a test results from a misconstruction of the decisions of the Supreme Court.

As is well known, a corporation, except in a few instances, is an entity, distinct from the stockholders. When it has earnings, the stockholders do not, by reason of that fact, have income. When it segregates those earnings, even though such earnings have accumulated in a surplus, and declares a dividend payable in money, then the stockholder receives income,[1] or if the corporation takes from its surplus, assets and distributes them in kind to the stockholders, the latter derives income.[2] If the corporation keeps its earnings or profits and allows them to accumulate thus building up a surplus, the surplus belongs to the corporation, not the stockholders, and while the value of the stock may increase, the stockholders do not realize on the profits until the surplus, or part thereof is distributed to them, or until they dispose of their stock.

When the corporation accumulates a surplus, and then declares and distributes a dividend of its own stock, to determine whether the stockholders have received "income," actually and really is to determine whether the corporate earnings have been divided, segregated, or set apart for the stockholders. Thus if the corporation has only one class of stock, the stock dividend is not a representation of a division or segregation of earnings, because the distributed stock gives the stockholders nothing which they did not already have. The proportionate interests are the same, the value of the original stock decreases to the extent of the value of the distributed stock, and the net result is that the stock-

[1] Lynch v. Hornby, 247 U. S. 339

[2] Peabody v. Eisner, 247 U. S. 347

holder's shares have been split into two interests.[3] The same thing is true where the corporation transfers its assets to a second corporation in return for the latter's stock, and then exchanges such stock for its stock.[4]

Where the corporation has more than one class of stock, outstanding, and distributes a stock dividend to one class only, then the proportionate interests in the corporation are changed, because the class of stockholders who receive the dividend then have a greater interest in the assets of the corporation than those who did not receive the stock dividend.[5] There being a change in the proportionate interests, the recipients of the stock dividend have derived income. The same result obtains where the corporation transfers its assets to a second corporation in return for its stock, and then distributes as a dividend the stock of the second corporation. That portion of the distributed stock which represents surplus and profits, is a segregation of such profits, for the use of the stockholders in the first corporation and is income derived by them.[6]

Therefore, we believe the real test to be used in determining whether the stockholder who receives a dividend of stock in the same corporation has received income, is whether the distribution effects a change in the proportionate interests of the stockholders.

In the instant case, when the stock dividend was made there were two classes of stockholders. Both received the stock dividend, but the record does not show whether the proportionate interests changed. When the distribution of $121,680.43 was made in non-voting common stock, there was outstanding $397,471.25 in voting common stock, and $819,333.06 in non-voting common stock, making a total of $1,216,804.31. If the voting common stockholders received the same proportion of the distribution as $397,471.25 bears to $1,216,804.31, then we think petitioner had no "income" but if they received a different proportion than the one specified, petitioner derived "income."

The decision is reversed, and the cause is remanded for further proceedings in accordance with this opinion.

[Endorsed:] Opinion. Filed Oct. 22, 1941. Paul P. O'Brien, Clerk.

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[3] Towne v. Eisner, 245 U. S. 418; Eisner v. Macomber, 252 U. S. 189.

[4] Weiss v. Stearn, 265 U. S. 242.

[5] Koshland v. Helvering, 298 U. S. 441; Helvering v. Gowan, 302 U. S. 238.

[6] United States v. Phellis, 257 U. S. 156; Rockefeller v. United States, 257 U. S. 176; Cullinan v. Walker, 262 U. S. 134; Marr v. United States, 268 U. S. 536.

Judgment

This Cause came on to be heard on the Transcript of the Record from the United States Board of Tax Appeals and was duly submitted:

On consideration whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Board of Tax Appeals in this Cause be, and hereby is reversed, and that this cause be, and hereby is remanded to the said Board of Tax Appeals for further proceedings in accordance with the opinion of this court.

[Endorsed:] Judgment. Filed and entered October 22, 1941. Paul P. O'Brien, Clerk.

Certificate of Clerk, U. S. Circuit Court of Appeals for the Ninth Circuit, to record certified under Rule 38 of the revised rules of the Supreme Court of the United States

I, Paul P. O'Brien, as Clerk of the United States Circuit Court of Appeals for the Ninth Circuit, do hereby certify the foregoing fifty-eight (58) pages, numbered from and including 1 to and including 58, to be a full, true, and correct copy of the entire record of the above-entitled case in the said Circuit Court of Appeals, made pursuant to request of counsel for the respondent, and certified under Rule 38 of the Revised Rules of the Supreme Court of the United States, as the originals thereof remain on file and appear of record in my office.

Attest my hand and the seal of the said the United States Circuit Court of Appeals for the Ninth Circuit, at the City of San Francisco, in the State of California, this 23rd day of December 1941.

[SEAL] PAUL P. O'BRIEN, *Clerk*.

U. S. GOVERNMENT PRINTING OFFICE, 1942

SUPREME COURT OF THE UNITED STATES

Order allowing certiorari

Filed May 11, 1942

On petition for writ of certiorari to the United States Circuit Court of Appeals for the Ninth Circuit.

The order of this Court dated March 2, 1942, denying certiorari in this case is vacated. The petition for writ of certiorari herein is granted, and the case is assigned for argument immediately following No. 1100, Strassburger vs. Commissioner of Internal Revenue.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

U. S. GOVERNMENT PRINTING OFFICE 1942